David Stubbs
Primary Markets Policy
Financial Conduct Authority
12 Endeavour Square
London E20 1JN
By email: cp19-07@fca.org.uk

27 March 2019

Dear Mr Stubbs

Re: BVCA response to FCA CP19/7 – Consultation on proposals to improve shareholder engagement (the "Consultation")

We are writing on behalf of the British Private Equity and Venture Capital Association ("BVCA"), which is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 770 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional investors and advisers. Over a period of five years (2013-2017), BVCA members have invested over £32bn into nearly 2,500 UK companies. Our members currently back around 3,380 companies, employing close to 1.4 million people on a full-time equivalent basis ("FTEs") across the world. Of these, around 692,000 FTEs are employed in the UK. Of the UK companies invested in during 2017, around 83% were SMEs. Between 2013 and 2017, BVCA members rescued 91 companies experiencing trading difficulties, helping safeguard over 37,000 jobs.

The BVCA is delighted to have the opportunity to respond to the FCA's Consultation on proposals to improve shareholder engagement.

1. The private equity and venture capital model

Before responding to the questions in the Consultation, we would first like to provide some background on the types of arrangements in which BVCA members typically participate and the likely application of the rules on shareholder engagement in the revised Shareholder Rights Directive[1] ("**Directive**") to those arrangements.

PE/VC firms are long-term investors, typically investing in unquoted companies (often referred to as "portfolio companies") for around three to seven years. This is a commitment to building lasting and sustainable value in business.

1.1. How PE/VC firms structure their funds with investors

A PE/VC fund is typically structured as a limited partnership, created through detailed negotiation between investors (the "limited partners") and the PE/VC manager (also known as the "general partner") and their legal advisers. This results in a governing document (for example, the limited partnership agreement) that sets out the key terms of the fund. The governing documents are heavily negotiated between PE/VC firms and their investors and professional advisers.

[1] Directive 2017/828

The PE/VC firm owns the general partner (one of the partners in the fund) and the fund manager, which manages the fund. PE/VC firms are regulated by the Financial Conduct Authority in the UK and subject to various reporting and disclosure requirements, including under the Alternative Investment Fund Managers Regulations 2013.

Investors make commitments to invest in the fund, i.e. the amount they originally agree to subscribe to the fund. The amount committed is not paid immediately on a fund's closing but in tranches over the commitment period on an "as needed basis" (typically four to seven years).

Investors in PE/VC funds are typically institutional and sophisticated investors. This includes pension funds, university endowments, insurance companies, sovereign wealth funds, funds of funds, corporate investors and private individuals. Further detailed information on the investor base can be found in our annual survey.[2]

1.2. How PE/VC firms invest

The fund invests in a number of unlisted portfolio company operating groups, typically aiming for a measure of diversification by geography, sector, etc.

In many cases, the fund will take a controlling position in the equity of the holding company (but this varies between private equity and venture capital strategies). Members of the management team of the portfolio company itself will often also have a shareholding, in order to incentivise them.

Third party banks may lend to each portfolio company group. There is typically no cross-collateralisation or exposures between one portfolio company group and any of the others. Each investment is in its own silo, separated from the others.

1.3 Relevance of the Directive to PE/VC firms

In our view, the shareholder engagement provisions of the Directive are not, for the most part, intended to address the activities of private equity and venture capital firms but are principally aimed at those of traditional fund managers with small holdings in listed companies. Private equity and venture capital firms already have a high level of active engagement in the businesses in which they invest and the investors, who are sophisticated entities, will have invested on that basis. Further, private equity firms usually only have a holding in listed shares in the case of: "public to private" transactions in which a PE firm acquires a sufficiently large stake in a listed company to de-list the company; or on IPO of a portfolio company where the firm may retain a stake and reduce this over time.

However, notwithstanding the above, there are some areas where the FCA's proposed rules may impact private equity and venture capital firms and therefore we would like to provide our feedback on the questions in the Consultation.

[2] BVCA Report on Investment Activity 2017 – available here

BI/CA

2. Response to consultation questions

Q1: Do you agree that the territorial scope of the rules framework should extend beyond that envisaged by the Directive?

We agree with the FCA's proposals to apply the rules framework to branches of non-EEA investment firms authorised by the FCA in order to create a level playing field.

However, while we understand the FCA's rationale for its proposed extension of the scope of the rules framework to shares in companies admitted to trading on a comparable market outside the EEA, we do have two concerns about this proposal.

Firstly, this creates a greater burden for UK asset managers than those in other EEA jurisdictions. This increased regulatory burden for UK asset managers could put them at a commercial disadvantage to those other EEA asset managers. As a result, asset managers considering whether to establish operations in the UK may prefer to set up in an EEA jurisdiction with a less burdensome regulatory regime.

Secondly, the definition of "comparable market" is not particularly clear. This is effectively included in the expanded definition of "regulated market" and is defined as:

> *"a market situated outside the EEA States which is characterised by the fact that:*
>
> *(a) it meets comparable requirements to those set out in (1)* [i.e. the MiFID II definition of regulated market]*; and*
> *(b) the financial instruments dealt in are of a quality comparable to those in a regulated market in the United Kingdom."*

This amounts to a new regulatory classification and one which requires quite a high level of subjective interpretation by UK asset managers and therefore would lead to uncertainty for those entities as to whether a particular investment falls within the scope of the rules. We recommend that wherever possible the FCA should avoid introducing new categories of regulatory classification when amending its rules. One of the major concerns we have with the current state of the FCA rulebook is the level of complexity, which is partly due to a tendency to keep introducing new categories every time there is a rule change. The cumulative effect of this is that certainty of interpretation and commonality of understanding is sacrificed at the expense of precise tailoring of the rules. As a result, UK asset managers may also incur additional costs (including possible legal costs) in carrying out this analysis in respect of a particular investment.

On that basis, we think that the better approach would be to restrict the scope of the rules framework to shares traded on a regulated market, as envisaged by the Directive.

Q2: Do you agree with our proposed amendments to the Handbook to implement the Directive requirements around engagement policies? If not, please explain what alternative approach you would like us to take.

As discussed above, we do not think that engagement policies are generally relevant for our members. Therefore, if the proposals remain as drafted, we expect that the vast majority of our members will either conclude they are not subject to the proposals on the basis that they do not invest in shares traded on a regulated market or would instead publish an explanation of why they have chosen not to comply (on the basis that they are covered only because they invest with a view to taking companies private or hold securities for a short period following a sale by way of IPO).

We note that requirement under the Directive (as reflected in the proposed amendments to the Handbook) is for there to be "a clear and reasoned explanation" for any decision not to comply. Given the nature of private equity and venture capital investments and the underlying investors, we do not think that an extensive explanation is always appropriate or necessary.

Q3: Do you agree with our proposed approach to implementing article 3h of the Directive? If not, please explain what alternative approach you would like us to take?

We note that these proposals impose obligations directly on UK insurance companies when appointing third party investment managers. Amongst other things, they require the insurance company to make certain public disclosures relating to that appointment.

We have two comments on this aspect of the proposals.

Our first is that our understanding of the Directive is that it is limited to life insurers to the extent they are investing in shares admitted to trading on a regulated market. We welcome the recognition of this in SYSC 3.4.2R. Accordingly, the disclosure requirements in SYSC 3.4.9R are limited to the management of shares admitted to trading on a regulated market. It would be helpful if the FCA could confirm this in the policy statement.

Our second is that the definition of SRD asset manager for the purposes of these rules is unclear as to whether it is intended to cover non-EEA asset managers which are not themselves subject to the full requirements of MIFID II or AIFMD. It would be helpful if the FCA could clarify its intention in the policy statement. We note that there is a difference between the definition of "SRD asset manager" which is relevant for the proposed life insurer provisions in SYSC 3.4 and the list of managers in COBS 2.2B.1R to which requirements apply directly. It would be useful if the FCA could comment on this in the policy statement.

Q4: Do you agree with our proposed amendments to implement the Directive requirements on asset managers reporting to asset owners? If not, please explain what alternative approach you would like us to take.

As discussed above, the business and investment model for private equity and venture capital funds differs to a large extent from that of transitional asset managers. In addition to legal and regulatory reporting obligations, there are voluntary codes which include disclosure requirements such as the Walker Guidelines for Disclosure and Transparency in Private Equity. Therefore, we think that it is

important that there is flexibility as to how asset managers make such disclosures and agree that the FCA should not prescribe any particular method of disclosure.

We note that the rule in COBS 2.2B.9R (requiring disclosure to pension schemes and life insurers) is not subject to the "comply or explain" provision proposed in COBS 2.2B.5R covering the rules on public disclosure in COBS 2.2B.6 and 7 R. Nevertheless, we understand the disclosures are limited to listed equities. Accordingly, for a private equity or venture capital firm we would expect minimal or no disclosure.

In addition, we note that the Consultation states in paragraph 3.41 that the FCA will not require information which is required under other rules to be provided again under these rules. We think that this is important given the extensive disclosures which private equity firms and venture capital firms already are required to provide to investors. For example, private equity and venture capital firms regulated under the Alternative Investment Fund Managers Directive are already subject to wide-ranging requirements under that directive and related legislation.

Therefore, we would welcome guidance to be formalised in the FCA's rules that where information is provided to the relevant investor under another legal or regulatory requirement (even if such information is not publicly available) then the asset manager would not be required to provide that information again to that investor simply to show compliance with the new rules. It would also be helpful if the guidance could note that disclosure should be proportionate to the scale of investment in listed equities by the disclosing fund manager.

Q5: Are there any other points we should address in the Handbook in relation to the SRDII, for example by adding clarificatory rules or providing further guidance?

As discussed above, we think that the rules are predominantly aimed at traditional asset management arrangements rather than venture capital or private equity arrangements. While we understand that the FCA's discretion is somewhat constrained by the text of the Directive, we nevertheless feel that, to the extent possible, the FCA's rules should permit flexibility in the level of information to be provided, taking into account the level of sophistication and information needs of the investors as well as the asset managers' obligations to provide information under other legal and regulatory requirements.

Q6: Do you agree with how we are proposing to implement SRD II requirements on related party transactions in the DTRs (including our proposal to replicate existing LR provisions so far as possible and choosing a threshold of 25%)? If not, please explain what alternative approach you would like us to take.

We do not have any comments on these proposals.

BVCA

Q7: Do you agree with our proposed amendment to the LRs – in particular that we should extend our rules for related party transactions to all issuers with a premium listing (except those subject to LR 16) or with a standard listing of shares that have their registered office outside of the UK or other EU Member State? Further, do you agree that we should give recognition to compliance with equivalent standards in non-EU jurisdictions and, if so, what are your views on how this could best be achieved?

We do not have any comments on these proposals.

Q8: Are there any other points we should address in our rules for related party transactions in relation to SRD II?

We do not have any comments on these proposals.

Q9: Do you agree with the conclusion and analysis set out in our cost benefit analysis?

We have not carried out a full survey of our members and therefore are not in a position to respond to this question.

However, as discussed in our response to Question 1, we have concerns that asset managers may incur additional costs resulting from the analysis required to establish whether an equity is listed on a "comparable market" on the basis of the current proposed definition.

We would be happy to discuss the contents of this letter with you; please contact Tim Lewis at tim.lewis@traverssmith.com and Tom Taylor (ttaylor@bvca.co.uk).

Yours faithfully,

Tim Lewis
Chair, BVCA Regulatory Committee